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PREFERENCES UNDER SECTION 60 OF THE BANKRUPTCY ACT

(In Defense of a Much-Maligned Section)

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The problem of preferences in bankruptcy is an old and difficult one. It presents, perhaps, the most complex problems in the administration of the Bankruptcy Act.

It is very difficult for the average lay person and some lawyers to understand why, if a debtor is *benevolently* inclined towards you, he cannot give you "the preferred treatment." Perhaps all of it may be traced to the fact that the condemnation of preferences is of modern origin.

I. *Preferences at Common Law and in the Bankruptcy Act*

At common law, a debtor could prefer one creditor to another and liquidate his debt to him in preference to others, so long as the matter was done in good faith and the transfer was not impressed with a secret trust for the benefit of the debtor.[1]

Modern bankruptcy statutes disapprove preferences whereby a favored unsecured creditor, not otherwise entitled to priority by virtue of either state or federal law, obtained from an insolvent debtor a greater share of his debt than he would secure upon liquidation through bankruptcy. The reason for this objection is that one of the fundamental aims of the bankruptcy statute is "equality of distribution."[2]

The doctrine of voidable preferences is thus of purely statutory origin. Appearing in embryonic form in some early acts, it found full recognition in the Act of 1898.[3] The codifiers of the present statute found the language of the old section 60 cumbersome, confusing, and unsatisfactory. They characterized the definition of preference as "not a scientific one."[4] Accordingly, the present section 60[5] is a broad enactment which covers fully the

[1]A leading Massachusetts case, Baker v. Chisholm, 268 Mass. 1, 3, 167 N.E. 321, 322 (1929), has stated the principle in this language: "It is settled that at common law, apart from any inhibiting statute, a debtor may lawfully prefer one creditor above others and may appropriate his property for the benefit of one or more creditors to the exclusion of others. The only limitation on such transactions is that there can be no secret trust for the benefit of the debtor." *See* Johnson-Baillie Shoe Co. v. Bardsley, Elmer & Chisholm, 237 Fed. 763, 767 (8th Cir., 1916).

[2]Moore v. Bay, 284 U.S. 4 (1931); Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215, 219 (1941). *See* James Angell McLaughlin, *Defining a Preference in Bankruptcy*, 60 HARV. LAW REV. 233 (1946).

[3]30 Stats. 562, c. 541, § 60, July 1, 1898.

[4]*Report of the House Judiciary Committee on Chandler Act*, as quoted in REMINGTON ON BANKRUPTCY, vol. 4A, 5th ed., § 1656, 88-89.

[5]11 U.S.C.A., § 96.

subject of preferences and the means of avoiding them. Despite the criticism directed at the old act, the jurisprudence which has arisen under it, in the main, was retained. Consequently the new jurisprudence under the present act dovetails into the prior one. Together they provide as comprehensive a coverage of the broad realm of voidable preferences as may be found in any branch of bankruptcy law.

It is not the aim of this study to analyze in detail all the law which has thus developed. Rather, the object is to discuss certain of the *most current problems* which arise under the law of preferences. Before doing so, it is well to emphasize the distinction which is often overlooked between preferences and fraudulent transfers which are condemned by the Bankruptcy Act[6] and made an act of bankruptcy.[7]

Fraudulent transfers are denounced because they bear the badge of fraud. The former are condemned because they go counter to the object of the bankruptcy law *to treat all creditors as equals.* If a preference disturbs that equality, it will be rejected, despite the absence of any element of fraud. This distinction is fundamental in the law of bankruptcy and has been emphasized by the Supreme Court repeatedly.[8]

II. *The Nature of Preferences*

These premised, we now consider the main provisions of the section. Subdivisions (a)(1) and (a)(2) of the section define a preference.[9]

[6]Bankruptcy Act, § 67(a)(1), 11 U.S.C.A., § 107(a)(1); § 67(d)(6), 11 U.S.C.A., § 107(d)(6); § 70(e)(1), 11 U.S.C.A., § 110(e)(1). The preferences here discussed are voidable and are to be distinguished from the liens which these sections declare "null and void."

[7]Bankruptcy Act, § 3(a)(1), 11 U.S.C.A., § 21(a)(1).

[8]Mr. Justice Lamar has stated the principle in the leading case of Van Iderstine v. National Discount Co., 227 U.S. 575, 582 (1913): "the statute recognized the difference between the intent to defraud and the intent to prefer, and also the difference between a fraudulent and a preferential conveyance. One is inherently and always vicious; the other innocent and valid, except when made in violation of the express provisions of a statute. One is *malum per se* and the other *malum prohibitum*—and then only to the extent that it is forbidden. A fraudulent conveyance is void regardless of its date; a preference is valid unless made within the prohibited period." *See* Coder v. Arts, 213 U.S. 223, 241-244 (1909); Dean v. Davis, 242 U.S. 438, 444 (1917).

[9]"(a)(1) A preference is a transfer, as defined in this title of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this title, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class. (2) For the purposes of subdivisions (a) and (b) of this section, a transfer of property other than real property shall be deemed to have been made or suffered at the time when it became so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee. A transfer of real property shall be deemed to have been made or suffered when it became so far perfected that no subsequent bona fide purchase from the debtor could create rights in such property superior to the rights of the transferee. If any transfer of real property is not so perfected against a bona fide purchase, or if any transfer of other property is not so perfected against such liens by legal or equitable proceedings prior to the filing of a petition initiating a proceeding under this title, it shall be deemed to have been made immediately before the filing of the petition." Bankruptcy Act, § 60(a)(1), 11 U.S.C.A., § 96(a)(1). A preference is made an act of bankruptcy. Bankruptcy Act, § 3(a)(2), 11 U.S.C.A., § 21(a)(2).

In this very comprehensive definition we have the conditions which must exist before an avoidable preference arises. We state them briefly.

(a) *There must be a transfer.*[10]

The definition is broad enough to cover almost any transfer of property, money or thing of value from one person to another. And the effect is the same whether the transfer is voluntary or involuntary.

In this respect, the law codifies a principle which was declared early in the history of bankruptcy law that if a transfer has the earmark of a preference, it matters not that the debtor may have been importuned or coerced by the creditor into making the transfer.[11] Or even that, after placing into the hands of the creditor the means of preference, he may have actually taken steps to resist the efforts to secure the benefit of the transfer.

(b) *The transfer must be of property of the debtor.*

The property must be that of the debtor. And it must be property which could be subjected to the payment of his debts in bankruptcy. It follows that if the property is exempt, any transfer of it could not amount to a preference because exempt property cannot be applied to the satisfaction of the creditor's debts. As to it, no one is a creditor.[12]

(c) *The transfer of the property must be made for the benefit of the creditor.*

Thus, in a case arising in Alaska, where the trustee of a bankrupt coal company sought to recover money which had been deposited in the bank by one of its officers as trustee, the Court held that in the absence of a showing that the money was that of the bankrupt company, the bank was not "a creditor of the Matanuska Coal Company, either as an Alaska or Oregon corporation, or that the Matanuska Coal Company ever deposited any money with the bank, or was at any time indebted to the defendant bank in any

[10]And a transfer is defined in the Act in this manner: "'Transfer' shall include the sale and every other and different mode, direct or indirect, of disposing of or of parting with property or with an interest therein or with the possession thereof or of fixing a lien upon property or upon an interest therein, absolutely or conditionally, voluntarily or involuntarily, by or without judicial proceedings, as a conveyance, sale, assignment, payment, pledge, mortgage, lien, encumbrance, gift, security, or otherwise." Bankruptcy Act, § 1(30), 11 U.S.C.A., § 1(30).

[11]Clarion Bank v. Jones, 21 Wall. 325, 340-341 (1874). The word "suffered" found in subdivision (a) (1), 11 U.S.C.A., § 96(a) (1), is found in many of the prior acts. Courts have had opportunity to interpret its meaning. Without going into detailed analysis of these rulings, it may be stated, generally, that the word implies circumstances showing a desire on the part of the debtor to give preference or to allow a proceeding to be instituted against him. There need, however, be no active cooperation. *See* Wilson v. Nelson, 183 U.S. 191 (1901); Golden Hill Distilling Co. v. Logue, 243 Fed. 342 (6th Cir., 1917); Corney v. Saltzman, 22 F.2d 268 (2d Cir., 1927).

[12]First National Bank v. Lanz, 202 Fed. 117 (5th Cir., 1913); In re Shurte, 39 F.2d 100 (D.C. Ill., 1930); and *see* the writer's opinion in In re Johnson, 97 F.Supp. 779 (1951); *see, also,* Myers v. Matley, 318 U.S. 622 (1943).

sum of money whatever, or that it paid any sum of money to the defendant bank as and for an indebtedness to the bank or otherwise."[13]

(d) *The transfer must be made for or on account of an antecedent debt.* This means that the debt which it is sought to liquidate must have existed prior to the time of liquidation. If the transfer is made for a contemporaneous debt, whether in the form of an exchange or otherwise, the condition is not satisfied. And this is the uniform ruling under the old law as well as the new.

R. Crawley Jones, a farmer and country store owner, was pressed by a bank to take up some notes bearing endorsement which the lender claimed had been forged. Fearing arrest, he appealed to his brother-in-law, Dean, for a loan of $1,600. The latter provided the money with which the notes were taken up. To repay them, the farmer executed a mortgage deed of trust to his property, including his stock in trade. After Jones was adjudicated a bankrupt, the transaction was challenged by the trustee in bankruptcy as a preference. Although sustaining the challenge on other grounds, the Supreme Court rejected the challenge on that ground, saying:

> The mortgage was not voidable as a preference under § 60b. Preference implies paying or securing a pre-existing debt of the person preferred. The mortgage was given to secure Dean for a substantially contemporary advance. The bank, not Dean, was preferred. The use of Dean's money to accomplish this purpose could not convert the transaction into a preferring of Dean, although he knew of the debtor's insolvency. Mere circuity of arrangement will not save a transfer which effects a preference from being invalid as such. *National Bank of Newport* v. *National Herkimer County Bank,* 225 U.S. 178, 184. But a transfer to a third person is invalid under this section as a preference only where that person was acting on behalf of the creditor, as in *In re Beerman,* 112 Fed.Rep. 663, and *Walters* v. *Zimmerman,* 208 Fed.Rep. 62, 220 Fed.Rep. 805. Here Dean acted on the debtor's behalf in providing the money and taking up the notes."[14]

In a more recent case, where the bankrupt's father-in-law engaged in the transaction commonly known as "kiteing" of checks for the purpose of making the son-in-law's commercial account "look better," the Court held that the transaction involved a transfer of property in payment of a contemporaneous debt, saying:

> "The father-in-law believed that the checks were good when the exchanges were made; he never agreed to withhold the depositing of any of them and he always sent them to the bank as soon as he made his next deposit in the regular course of his own business, which would usually be the following day or the day thereafter."[15]

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[13]Bank of Anchorage v. Conroy, 284 Fed. 929, 931 (9th Cir., 1922).
[14]Dean v. Davis, 242 U.S. 438, 443 (1917).
[15]Bostian v. Levich, 134 F.2d 284, 286 (8th Cir., 1943).

The extent to which questions of this character turn upon the interpretation which courts place upon contemporaneous facts is illustrated by a case in the Ninth Circuit. There the bankrupt, a brokerage firm, had given to another brokerage company its check for the price of certain shares of stock. The certificates were delivered, but the check was refused payment. However, at the bankrupt's request, the brokerage firm retained the check and presented it twice more. Finally, the company accepted a promissory note secured by mortgage for the purchase money. Although the creditor did not make an effort to secure possession of the stock, which, in the meantime, had been hypothecated by the bankrupt, the Court held that the mortgage was a preference given for an antecedent debt, saying:

> "We agree with the special master in holding that, when the Staats Company accepted the mortgage, it was in lieu of cash, and that the transaction became one where the debtor, to secure an existing antecedent debt due by it to the creditor, gave security, and the creditor, confirming the sale accepted the security."[16]

(e) *The transfer must be made while insolvent.*

And insolvency in this section means what it means elsewhere in the act. It exists whenever the aggregate of the bankrupt's property exclusive of any property which he may have conveyed, transferred, concealed, removed or permitted to be concealed or removed with intent to defraud, hinder or delay his creditors is not at a fair valuation, sufficient in amount to pay his debts.[17]

(f) *The transfer must be made within four months* before the filing by or against the debtor of a petition under the title, i. e., under any of the provisions of the Bankruptcy Act.

(g) *The effect of the transfer must be to enable the creditor to obtain a greater percentage of his debt than some other creditor in the same class.*

This condition is usually referred to as "diminution of the estate." Indeed, it is of the essence of a preference that it undermine the equality which the Bankruptcy Act seeks to achieve. Thus, where the bankrupt, as a consideration for the assignment of a lease, was compelled to pay the arrears of the rent, the payment was held not to be a preference because it was not a diminution of the bankrupt's estate, the Court saying:

> "Upon the foregoing facts the district judge ruled that no preference was received. This was plainly right. To constitute a preference the transfer under attack must diminish the bankrupt's estate. *Continental & Commercial*

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[16]Security Trust & Savings Bank v. Wm. R. Staats Co., 233 Fed. 514 (9th Cir., 1916).

[17]Bankruptcy Act, § 1(19), 11 U.S.C.A., § 1(19). "Under the Bankruptcy Act, inability to meet current obligations is not insolvency, however. The test, rather, is the relation of the debtor's total assets to its liabilities." Cusick v. Second National Bank, 115 F.2d 150, 155 (U.S. App. D.C., 1940). *See* Trautwein v. Mandel, 127 F.2d 567, 569 (8th Cir., 1942).

Trust & Savings Co. v. *Chicago Title & Trust Co.*, 229 U.S. 435, 439, 444, 33 S.Ct. 829, 57 L.Ed. 1268. The payment of arrears of rent in order to obtain the lessor's consent to an assignment of the lease did not diminish the bankrupt's estate; on the contrary, it enabled the bankrupt to increase its estate by disposing of assets which otherwise would not have been saleable."[18]

And where a bankrupt transferred some promissory notes as collateral to a creditor in substitution of other collateral, the Court of Appeals for the Ninth Circuit held that the substitution did not constitue a preference, as there had been no diminution of the estate.[19]

III. *Time of Taking Effect*

Clause (a)(2) of section 60 is of great significance. Its original object was to definitely determine the time of the transfer in order to avoid the conflict in decisions under prior acts. It chose as a criterion a time when the transfer has been so perfected that no purchaser from the debtor or no creditor could acquire any rights superior to those of the transferee.

Soon after the enactment of this section, the Supreme Court gave us a very authoritative interpretation of its meaning in a very instructive case.[20] The trustee in bankruptcy had brought suit in the Supreme Court of New York to recover the sum of $150,000 paid by the bankrupt upon the ground that it was an unlawful preference. The New York Court granted summary judgment on the ground that the transfer did not occur within four months of bankruptcy. This decision having been sustained by the New York Court of Appeals, the case came before the Supreme Court on certiorari. The facts in the case were very simple. The bankrupt had mailed to the respondent a check for $150,000 more than four months before bankruptcy. The debtor received it and credited it to the bankrupt's antecedent debt within the four months. The question before the Court was whether the transfer was a preference. The first point which the Court decided was that what constitutes a transfer and when it is complete is "necessarily a federal question since it arises under a federal statute intended to have uniform application throughout the United States."[21]

But the Court found no federal statute which determined the rights acquired by the creditor and the time of vesting of those rights. It, therefore, held that state law controlled, saying:

"In the absence of any controlling federal statute, a creditor or bona fide purchaser could acquire rights in the property transferred by the debtor, only by virtue of a state law. And hence section 60(a)'s 'apparent command

[18]Bachner v. Robinson, 107 F.2d 513, 514 (2d Cir., 1939); and *see* Continental & Commercial Trust & Savings Co. v. Chicago Title & Trust Co., 229 U.S. 435, 439 (1913); Daniel Hamm Drayage Co. v. Wilson, 178 F.2d 633, 638 (8th Cir., 1949).

[19]Roberts v. Yegen, 12 F.2d 654 (9th Cir., 1926).

[20]McKenzie v. Irving Trust Co., 323 U.S. 365 (1945).

[21]McKenzie v. Irving Trust Co., *supra* p. 370.

is to test the effectiveness of a transfer, as against the trustee, by the standards which applicable state law would enforce against a good faith purchaser.' *Corn Exchange Bank* v. *Klauder,* 318 U.S. 434, 436-7. See, also, *Benedict* v. *Ratner,* 268 U.S. 353, 359 and cases cited. Section 60a in this respect, as do numerous other federal statutes, see *Davies Warehouse Co.* v. *Bowles,* 321 U.S. 144, 155-156, and note 20, and cases cited, thus adopts state law as the rule of decision. The state standards which control the effectiveness of a transfer likewise determine the precise time when a transfer is deemed to have been made or perfected."[22]

The highest court of New York having determined that the transfer was perfected on the mailing of the check, the Supreme Court affirmed the ruling by following state law.

But, while this decision, in which state law worked in favor of the particular transaction, met with approval, another decision which preceded it and in which, through the application of local law, an otherwise valid assignment was nullified, resulted in great dissatisfaction.[23] In that case, the debtor had assigned accounts receivable for current loans within four months. Because, under Pennsylvania law, notice was required to be given to those who owned the accounts and was not given, the Court held that the transaction was a preference. This decision and a lower court decision,[24] because they nullified the financial practice known as "non-notification financing," led to a movement for modification of the clause. The Judiciary Committee of the House of Representatives characterized the effect of these decisions in this manner:

"The resultant confusion has cast grave doubt upon the validity of normal business security, in all of the areas covered by trust receipts, factors' liens, oil leases, cattle loans, airplane-equipment financing, chattel mortgages, assignments of accounts receivable, conditional sales agreements for resale, etc. Indeed, a bank officer, who appeared as one of the witnesses at the subcommittee hearing, testified that the situation had come to such a pass that his institution was compelled to regard all such types of transactions as unsecured loans, and to rule on them, as to the terms which his bank was willing to enter into them, accordingly."[25]

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[22]McKenzie v. Irving Trust Co., *supra* p. 370.

[23]Corn Exchange National Bank & Trust Co. v. Klauder, 318 U.S. 434 (1943). *See* Fifth Third Union Trust Co. v. Kennedy, 185 F.2d 833 (2d Cir., 1950). A voluminous critical literature has been directed to section 60(c) as interpreted in the Klauder case, and as it stood before the 1950 amendment. The chief objection is that "the section threatens to invalidate, if it does not, against the trustee security interests on inventories, such as trust receipts, factors liens, mortgages, or stocks of goods and conditional sales for resale, which are not meant to be good against purchasers in due course of business." John Hanna, *Preferences as Affected by Section 60(c) and 67(b) of the Bankruptcy Act, 1950,* 25 Wash. Law Rev. 1, note 1. This note also lists the chief articles on the subject. *See, also,* Eugene J. T. Flanagan, *Assignments of Accounts Receivable and the Conflict of Laws Under the Bankruptcy Act,* 2 Vand. Law Rev. 409 (1949).

[24]In re Vardaman Shoe Co., 52 F.Supp. 562 (D.C. Mo., 1943). Disapproved in In re Rosen, 157 F.2d 997 (3d Cir., 1946).

[25]H.R. Rep. No. 1293, 81st Cong., 1st Sess. (August 22, 1949), to accompany S. 88, as quoted in 3 Collier on Bankruptcy, 14th ed., § 60.38.

As a result, the entire subsection (a) was recast in 1950 into an elaborate statute with many subdivisions. The committee has stated the objectives of this new section in this manner:

> "(a) To retain unimpaired the basic object of the 1938 amendment, which eliminated the 'relation back' doctrine of *Sexton* v. *Kessler*, and the 'pocket lien' doctrine of *Carey* v. *Donohue*, referred to above; (b) to eliminate the evil of allowing a trustee in bankruptcy to take the position of a potential and artificial bona fide purchaser, and to restore him to the position of a lien creditor, in harmony with his functions under the Bankruptcy Act; and (c) in effectuation of said policy, to provide that no transfer made in good faith, for a new present consideration, shall constitute a preference to the extent of such consideration actually advanced, if the provisions of applicable state law governing the perfection of such transfer are complied with, with an appropriately rigid time limitation (21 days) for such perfection if such limitation is not itself prescribed by the applicable state law."[26]

The change made in clause (a)(2) does not affect real estate transactions. As to them, the bona fide purchaser test remains. As to purchasers who are not bona fide purchasers and as to transfers of personal property, the effective time of the transfer is determined by reference to the rights of lien creditors. And it is declared that the transfer shall be deemed to have been made when it has been so far perfected that no lien obtained by legal or equitable proceedings could become superior to the rights of the transferee.

We refer briefly to some of the most salient provisions of the other clauses. (*What follows is a mere paraphrase, emphasizing the most significant features. It is not intended to be all-inclusive.*) The transfer time is made applicable whether or not there are or were creditors who might have obtained such liens or whether there were or were not persons who might have become bona fide purchasers.[27] Liens obtainable by legal or equitable proceedings are defined as liens arising in the ordinary course of such proceedings upon the entry of a judgment or decree, attachment, garnishment, execution, or similar process, whether secured before, upon or after judgment or decree, or before or upon levy. Liens which are given a special priority or which are prior in time are excluded.[28]

The superiority of such lien is recognized if it flows from the lien or purchase itself or from such lien or purchase followed by any step entirely within the control of the lienholder or purchaser with or without the aid of the ministerial action by public officials. If the concurrence of a third party is necessary, such as payment or an agreement to pay or a judicial action

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[26]H.R. Rep. No. 1293, 81st Cong., 1st Sess. (August 22, 1949), to accompany S. 88, as quoted in 3 COLLIER ON BANKRUPTCY, 14th ed., § 60.38.

[27]Bankruptcy Act, § 60(a) (3), 11 U.S.C.A., § 96(a) (3).

[28]Bankruptcy Act, § 60(a) (4), 11 U.S.C.A., § 96(a) (4).

to perfect a lien, superiority is denied.[29] Where means exist for perfecting legal liens, but have not been employed, it is declared the policy of the section not to recognize equitable liens.[30]

With reference to transfers made for a new and contemporaneous consideration, if state law required recording, delivery of property or other steps to perfect a transfer, this must be done within 21 days or within a shorter time if the state law required such shorter time. This creates a definite period within which to perfect liens. In both instances, the date of actual execution determines the time of perfection, once the additional steps are performed within the limited time.[31]

A transfer to secure a future loan, if actually made, or a transfer which becomes security for a future loan is given the same effect as a transfer for a new and contemporaneous consideration.[32]

It is the contention of writers on the subject that certain transactions, unrecorded transfers, liens and mortgages, which have heretofore been held valid and "the pocket lien" to which the Committee referred[33] could now be set aside.[34]

I shall not indulge in similar speculations. But one observation is in order.

While we apply certain specific principles in bankruptcy administration, it is well to remember that the parties whose claims to the bankrupt estate come before us are persons who entered into contracts under state law. It may well be that, at times, a particular local law works to the advantage of a particular creditor. But so long as he and the other creditors did business with the debtor on the basis of state law, I cannot see the need of substituting for all local law general principles applicable to all bankruptcy cases. It will be found, no doubt, that, in many instances, we are actually depriving a creditor of a right which he had reasonable ground to believe he was entitled to when he entered into the particular transaction—a right the existence of which other creditors knew. Courts, in interpreting the meaning of transfers, constantly take into consideration those certain general principles which they assume the Congress took cognizance of when they denounced preferential transfers. Thus, for instance, it is recognized in banking law that a bank may apply a deposit within the four-months period to the liquidation of the depositor's debt. The Court of Appeals for the First Circuit assumed that the Congress knew of this general principle and declined to

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[29]Bankruptcy Act, § 60(a) (5), 11 U.S.C.A., § 96(a) (5).
[30]Bankruptcy Act, § 60(a) (6), 11 U.S.C.A., § 96(a) (6).
[31]Bankruptcy Act, § 60(a) (7), 11 U.S.C.A., § 96(a) (7).
[32]Bankruptcy Act, § 60(a) (8), 11 U.S.C.A., § 96(a) (8).
[33]Martin v. Commercial National Bank, 245 U.S. 513 (1918).
[34]3 COLLIER ON BANKRUPTCY, 14th ed., §§ 60.38-60.51.

hold that such act on the part of a bank was a condemned preference.[35] While conceding that the word "transfer" as used in section 60 has a wider significance than formerly, the Court in the particular case stated that "Congress had no intention of altering the accepted law as to bank deposits."[36]

So, while it is hoped that the 1950 legislation may overcome some of the deficiencies found in the old statute, as interpreted by the courts, I trust that the large body of good law developed on the subject of preferences will not be destroyed.

IV. *Preferences, Good and Bad*

For an examination of the cases shows that in pursuing the ideal of equality between creditors, the courts have, very realistically, applied the legal principles which obtain in commercial relations so as to give recognition to legitimate transactions and to repudiate those which, no matter how "dressed up," were, in reality, preferences.

To give a few illustrations:

Assignments of money which have the effect of giving to a particular creditor a larger share of the estate than he would otherwise receive have been denied validity. And this despite the fact that the money had actually been invested in a real estate trust.[37]

At the same time, where, under state law, the seller of automobiles on a conditional sales contract, was given the right to retake them, the act of retaking them within the prohibited period was held to be outside the prohibitions of the preference statute.[38]

Assignments of accounts to become due, if made for present consideration, cannot be attacked.[39]

First mortgage bonds have been held to be property within the meaning of the prohibition against preferences.[40] Where money was returned to certain creditors which had been obtained from them by fraudulent representation, and in the absence of any recognized liens upon the specific fund, the repayment within the four-months period was treated as a preference.[41]

An execution obtained within the four-months period is vulnerable, even though the judgment on which it was issued was obtained almost a year before

[35]Joseph F. Hughes & Co. v. Machen, 164 F.2d 983 (4th Cir., 1947).

[36]Joseph F. Hughes & Co. v. Machen, *supra* at 988.

[37]In re Moraine Hotel Co., 107 F.2d 550 (7th Cir., 1939).

[38]Finance and Guaranty Company v. Oppenhimer, 276 U.S. 10 (1928), and *see* Bailey v. Baker Ice Machine Company, 239 U.S. 268 (1915); McKenzie v. Irving Trust Co., 323 U.S. 365 (1945).

[39]Associated Seed Growers, Inc. v. Geib, 125 F.2d 683 (4th Cir., 1942).

[40]In re Advance Oil Co., 1 F.2d 440 (D.C. Penn., 1923); Appeal of Franklin Trust Co., 1 F.2d 442 (3d Cir., 1924).

[41]Cunningham v. Brown, 265 U.S. 1 (1924).

the filing of the petition in bankruptcy.[42] This case illustrates the wisdom of following local law, for the decision was based upon the ground that the judgment itself did not, under New York law, give a lien against the debtor's personal property.[43]

Money paid on a libelee's bond by a surety was held within the statute.[44] Mortgages obtained for previously unsecured debts are invalid.[45] Indeed, so heartless are some courts that they even invalidated a mortgage given to an attorney in contemplation of bankruptcy for future legal services.[46] Chattel mortgages are invalid if made on property of the debtor corporation.[47] So are payments on promissory notes.[48] And the rule applies to an endorser, guarantor or surety of a bankrupt's note who knows or has reasonable cause to believe that the maker of the note is insolvent at the date of its payment.[49]

The Court refused to recognize a predated check given in payment of a note and lend support to the theory that the creditor was merely procuring the return of his own money.[50]

In this respect, the courts have always considered *any* payment in any form as being a transfer of property.[51]

In dealing with bank transactions, courts have been very careful to recognize certain rights which banks acquire in relation to their depositors either under general or state law, and have held them to be out of the purview of the preference statute. So they have recognized the right to set off a debt against a customer's deposit.[52] They have also sustained bank liens recognized by state law.[53]

In fact, in examining these cases, old and new, one is struck by the fact that, in the absence of specific prohibitions in the bankruptcy law, courts have sustained transactions valid under state law against attacks as preferences. So, where, under state law, execution and delivery of a deed was valid without recordation, the right of a purchaser in good faith was recognized.[54]

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[42] Adler v. Greenfield, 83 F.2d 955 (2d Cir., 1936). *See* Von Segerlund v. Dysart, 137 F.2d 755 (9th Cir., 1943).

[43] New York Civil Practice Act, § 679.

[44] In re National Motor Ship Corporation, 96 F.2d 88 (2d Cir., 1938).

[45] In re Cox, 132 F.2d 881 (7th Cir., 1943).

[46] Quinn v. Union National Bank, 32 F.2d 762 (8th Cir., 1929).

[47] Trautwein v. Mandel, 127 F.2d 567 (8th Cir., 1942); In re LeMaire Cosmetic Co., 174 F.2d 749 (7th Cir., 1949).

[48] Watchmaker v. Barnes, 259 Fed. 783 (1st Cir., 1919).

[49] Fenold v. Green, 175 F.2d 247 (2d Cir., 1949).

[50] Watchmaker v. Barnes, 259 Fed. 783 (1st Cir., 1919).

[51] West Philadelphia Bank v. Dixon, 95 U.S. 180 (1877); Pirie v. Chicago Title & Trust Co., 182 U.S. 438 (1901).

[52] Joseph F. Hughes & Co. v. Machen, 164 F.2d 983 (4th Cir., 1947).

[53] Goggin v. Bank of America Nat. Trust & Savings Assn., 183 F.2d 322 (9th Cir., 1950).

[54] Bridgewater v. Schaefer, 164 F.2d 447 (5th Cir., 1947).

The 1950 amendment to section 60 calls for the recording also within not to exceed 21 days after the transfer.

When dealing with bankrupts, sometimes one feels like applying to them the story of the famed Dr. Samuel Johnson and the beggar. The beggar asked him for alms, adding, "I must live, Sir." The Doctor replied, "Why the necessity?" Nevertheless, courts do recognize that moneys advanced to members of the family, such as a wife, for legitimate expenses, do not constitute a preference, even though the wife may also be a creditor. We exclude, of course, the situations which show up in many of these cases where large payments to relatives appear on the eve of bankruptcy. They are of the character that might be classed as "vicarious generosity," the bankrupt remembering suddenly, and almost miraculously, all relatives who had "assisted" him with money and trying to liquidate their debts. The badge of fraud is upon all these.

Of the many other instances of various types of commercial transactions which the courts have had to scrutinize, reference will be made only to two more. Where certain materials were delivered by the bankrupt in payment of an antecedent debt, the Court had no difficulty in finding a preference.[55] On the other hand, payments upon an open account for goods sold are not ordinarily treated as preferences.[56]

These illustrations taken from decisions which preceded and those which followed the 1938 Act show a remarkable continuity of interpretation. Courts have aimed to achieve the equality which has been declared to be "the theme of the bankruptcy law," and, at the same time, they have sought to protect legitimate commercial transactions entered into under local statutes, and to guarantee to persons the benefit of general commercial and business practices, so long as they did not come in direct opposition with the Bankruptcy Act. It is to be hoped that the 1950 amendment to the section will not disturb too much this balanced approach.

V. *Transfer to Attorneys*

In what precedes, we have discussed what have come to be known as "the elements of a preference." The discussion has been limited to the wording of subdivisions (a)(1) and (a)(2) of section 60.

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[55]Oliver v. Staples & Pfeiffer, 67 C.A. 570 (1924). Where, however, 70 cars of melons belonging to the bankrupt had been assigned to a merchant for sale, the Court held that the transfer of the produce to the commission merchant occurred when the produce was consigned to the merchant and not at the time of sale and application of the proceeds to the merchant's demand against the grower. And it appearing that the commission merchant was not aware of the insolvency of the debtor at the time, the preference, if any occurred, was valid. *See* Half Moon Fruit & Produce Co. v. Floyd, 60 F.2d 799 (9th Cir., 1932).

[56]Jaquith v. Alden, 189 U.S. 78 (1903); Yaple v. Dahl-Millikan Grocery Company, 193 U.S. 526 (1904). Sale on limited credit is not consignment, Scott County Milling Co. v. Grayson, 88 F.2d 190 (5th Cir., 1937).

Equally important are the conditions laid down in subdivisions (b) and (c) of the section. But before discussing them, we treat briefly the question of transfers to attorneys and the provisions relating to bankruptcy of stock-brokers.

Subdivision (d) of section 60 reads:

> "If a debtor shall, directly or indirectly, in contemplation of the filing of a petititon by or against him, pay money or transfer property to an attorney and counselor at law, solicitor in equity, or proctor in admiralty for services to be rendered, the transaction shall be reexamined by the court on petition of the trustee or any creditor and shall be held valid only to the extent of a reasonable amount to be determined by the court, and the excess may be recovered by the trustee for the benfit of the estate."[57]

This provision was carried over from the older statute. Its object is to prevent the bankrupt from exercising undue generosity towards the attorney in the bankruptcy proceeding. This is achieved by permitting the bankruptcy court to reexamine the arrangement, and to cause the return to the estate of the bankrupt of any money or property paid to his attorney beyond a reasonable compensation for services. And the services to be rendered must relate *to the bankruptcy proceeding.* The jurisdiction of the court is exclusive. The Supreme Court, in a leading case, has characterized the provision as not being a case of preference or fraudulent conveyance. It is merely the right to examine whether certain agreements as to transfers of money or property to attorneys for future services are reasonable or not. In the particular case, the Court said:

> "This is not a case of preference, where part of the estate is transferred to a creditor so as to give to him more of the estate than to others of the same class under section 60 of the bankruptcy act, nor is it a case of fraudulent conveyance under section 67. It is a transfer in consideration of future services, to be reduced if found unreasonable in amount."[58]

And, speaking of the objects of the section, the Court took into consideration the temptation of the debtor to reward too generously, perhaps, the attorney who may be seeing him through his financial difficulties, saying:

> "Section 60d is *sui generis,* and does not contemplate the bringing of plenary suits or the recovery of preferential transfers in another jurisdiction. It recognizes the temptation of a failing debtor to deal too liberally with his property in employing counsel to protect him in view of financial reverses and probable failure. It recognizes the right of such a debtor to have the aid and advice of counsel, and, in contemplation of bankruptcy proceedings which shall strip him of his property, to make provisions for reasonable compensation to his counsel. And in view of the circumstances the act makes provision that the bankruptcy court administering the estate may, if the

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[57]Bankruptcy Act, § 60(d), 11 U.S.C.A., § 96(d).
[58]In re Wood and Henderson, 210 U.S. 246, 251 (1908).

trustee or any creditor question the transaction, reexamine it with a view to a determination of its reasonableness."[59]

In a later case, the Supreme Court had before it an order of a referee which had directed attorneys to turn over to the trustee in bankruptcy the sum of $2,000, which was a part of an amount paid to them by the bankrupt corporation for legal services rendered shortly before the filing of an involuntary petition. Admittedly, the money was paid for the purpose of securing a composition with the creditors. The jurisdiction of the referee to inquire into the matter being challenged, the Court said:

> "But, given the fact that the payment or transfer was in contemplation of bankruptcy, the inducement of the transaction affords, from the standpoint of the statute, sufficient ground for authorizing a summary inquiry into its reasonableness. The manifest purpose of the provision is to safeguard the assets of those who are acting in contemplation of bankruptcy, so that these assets may be brought quickly and without unnecessary expense into the hands of the trustee, and to provide a restraint upon opportunities to make an unreasonable disposition of property through arrangement for excessive payments for prospective legal services."[60]

And, as already appears,[61] courts have invalidated security given for such fees.[62]

VI. *Assets of Stockbrokers*

The elaborate scheme for unwinding assets of bankrupt stockbrokers cannot be treated in detail in a general discussion like this. The scheme set forth in subdivision (e) of section 60[63] was evolved in order to overcome the difficulties which arose under the old law, under the varied relationships between the stockbroker and his clients. The object of the section was to give recognition to customers who have specific claims to stock held to their account, and to cash customers who are entitled to immediate possession of securities without payment of any sum to the stockbroker and to general creditors. A fund is created to consist of all the property of the stockbroker, except that of the cash customers who are able to identify specifically their property. All property acquired constitutes a single and separate fund, and all customers, except cash customers, constitute a single and separate class of creditors entitled to share ratably in the fund on the basis of their respective net equities as of the date of bankruptcy.

The net equity is determined by excluding any specifically identifiable security reclaimable by the customer, and by subtracting the indebtedness

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[59] In re Wood and Henderson, *supra.*
[60] Conrad, Rubin & Lesser v. Pender, 289 U.S. 472, 477 (1933).
[61] In re Buchanan, 66 F.2d 416 (2d Cir., 1933).
[62] Quinn v. Union National Bank, 32 F.2d 762 (8th Cir., 1929).
[63] Bankruptcy Act, § 60(e), 11 U.S.C.A., § 96(e).

to the stockbroker from the sum which would have been owing by the stockbroker to the customer had the stockbroker liquidated, by sale or purchase on the date of bankruptcy, the remaining securities or security commitments of the customer. If the fund is not sufficient to pay in full the claims, they share in the general estate with the creditors. Perhaps the most important feature of this provision is the one which allows customers to reclaim their securities. And, wherever it has been possible to identify the stock for which payment was made, the courts have given full scope to the provision.[64] The Court of Appeals for the Third Circuit has given the section a broad interpretation. It has held that the object of the section is to cure inequalities among claimants of the same status.[65] It has stated the effect of the section in this manner:

> "The effect of section 60, subdivision e, was to place all margin customers of a stockbroker in a single and separate class whose participation in the distribution of the stockbroker's estate in bankruptcy is limited to the single and separate fund composed of the proceeds of such customer's property, rightfully transferred or unlawfully converted by the stockbroker, and in which fund such customer's share ratable according to their respective net equities as of the date of bankruptcy. Cash customers whose property had likewise been transferred or converted by the stockbroker are subject to the same provision unless the property (received by the stockbroker from them for sale, etc., or *for them pursuant to purchase*) remains in its identical form, as so received, until the date of bankruptcy or unless such property or any substitutes therefor or proceeds thereof were, more than four months prior to bankruptcy or while the stockbroker was insolvent, allocated to or physically set aside for such customers and so remained to the date of bankruptcy. The differentiation in the instances above noted between cash customers owning property identifiable in the broker's hands and margin customers is quite understandable."[66]

The few cases which have arisen under it indicate that the courts are interpreting the section so as to give effect to what one writer calls "a clear cut distinction between customers and general creditors of a broker."[67]

VII. *Avoiding a Preference*

We have left for the last the discussion of the manner of avoiding a preference. It is covered by subdivisions (b) and (c) of section 60. They read:

> "(b) Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference

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[64] In re McMillan, Rapp & Co., 38 F.Supp. 40, 45 (D.C. Penn., 1941) (claim of Weiss); In re McMillan, Rapp & Co., *supra* at 42 (claim of Thomas); In re McMillan, Rapp & Co., *supra* at 43 (claim of Leaver).

[65] In re McMillan, Rapp & Co., 123 F.2d 428, 431-432 (3d Cir., 1941).

[66] In re McMillan, Rapp & Co., *supra* at 430.

[67] 3 COLLIER ON BANKRUPTCY, 14th ed., § 60.76, p. 1108.

thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent. Where the preference is voidable, the trustee may recover the property or, if it has been converted, its value from any person who has received or converted such property, except a bona fide purchaser from or lienor of the debtor's transferee for a present fair equivalent value: *provided, however,* That where such purchaser or lienor has given less than such value, he shall nevertheless have a lien upon such property, but only to the extent of the consideration actually given by him. Where a preference by way of lien or security title is voidable, the court may on due notice order such lien or title to be preserved for the benefit of the estate, in which event such lien or title shall pass to the trustee. For the purpose of any recovery or avoidance under this section, where plenary proceedings are necessary, any state court which would have had juridiction if bankruptcy had not intervened and any court of bankruptcy shall have concurrent jurisdiction.

"(c) If a creditor has been preferred, and afterward in good faith gives the debtor further credit without security of any kind for property which becomes a part of the debtor's estate, the amount of such new credit remaining unpaid at the time of the adjudication in bankruptcy may be set off against the amount which would otherwise be recoverable from him."[68]

The first clause of subdivision (b) constitutes a departure from the law as it existed prior to 1938. Under the previous section, the preference was voidable if the creditor had a reasonable cause to believe that . . . "the transfer would affect a preference." The courts, in interpreting it, insisted that before a preference was voidable, it appear that the person receiving the preference had cause to believe that the transfer to him would give him a greater share of his debt than he would receive on liquidation.[69] Under the present statute, the transfer may be avoided if the transferee or his agent has reasonable cause to believe that the debtor is insolvent.

Under the old section, the existence of circumstances leading to the belief of insolvency were held sufficient from which to infer an intention to effect a preference.[70] But, theoretically, the beneficiary of the preference was made responsible for the intention of the debtor to prefer him.

It is conceivable that situations might arise where the person receiving such preference might be entirely ignorant of the intent with which the transfer is being made.[71] The present statute eliminates the element of

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[68]Bankruptcy Act, § 60(b) and § 60(c), 11 U.S.C.A., § 96(b) and (c). The duty to avoid preferences is also enjoined on the trustee by § 70(e)(2) of the Bankruptcy Act, 11 U.S.C.A., § 110(e)(2). The surrender of preferences under § 57(g) of the Bankruptcy Act (11 U.S.C.A., § 93(g)) will be treated separately. (See Part X of text, *infra.*) And, as the object of this study is to deal with the nature of preferences and their avoidance, only reference is made to the fact that a preference is declared an act of bankruptcy. (Bankruptcy Act, § 3(a)(2), 11 U.S.C.A., § 21(a)(2).

[69]Pirie v. Chicago Title & Trust Co., 182 U.S. 438 (1901); Cunningham v. Brown, 265 U.S. 1 (1924); Brown Shoe Co. v. Carns, 65 F.2d 294 (8th Cir., 1933); Jentzer v. Viscose Company, 82 F.2d 236 (2d Cir., 1936).

[70]Cunningham v. Brown, 265 U.S. 1 (1924).

[71]*See* Pirie v. Chicago Title & Trust Co., 182 U.S. 438 (1901).

knowledge in this respect. All it requires is that the creditor have reasonable cause to believe (a) that the debtor is insolvent, and (b) that the effect of the transfer be to give to the creditor a larger share of the assets than other creditors in his class would receive. The first element then relates directly to the knowledge of the creditor. The second is purely a matter of fact, regardless of the intent of the debtor.

In applying it the courts have eliminated circumstances which merely arouse doubt, or which, though they might appear ominous after bankruptcy, are not of a character to arouse suspicion at the time the transaction is entered into.[72]

In assaying each situation, the courts, of necessity, place themselves in the position in which the person receiving the preference is supposed to be. And if they find that circumstances were such that persons exercising ordinary judgment would have been compelled to act, they find reasonable cause to exist.

Thus, in a case which arose in the Seventh Circuit where it appeared, at the time the creditor took a mortgage, that the bankrupt owned no other real estate than the mortgaged forty acres, appraised at $1,600, and no personal property, other than hogs, cows and farming equipment; that loans had been made to him over a period of seven months in an amount of $1,375; that the notes had to be renewed without any reduction of principal; that the debtor had agreed to sell his hogs and reduce his debt, and had failed to do so; that another bank had inquired concerning the debtor's financial condition; that his father-in-law, to whom he owed $3,000, had formerly signed his notes as security, the Court concluded that the circumstances were such as to put the creditor "upon inquiry which, if undertaken, would have revealed insolvency."[73]

A decision of the Court of Appeals for the Ninth Circuit, in which I participated, presents a very interesting set of circumstances. The bankrupt operated a number of beauty shops, some of them in Los Angeles, others in various southern California cities. On January 6, 1947, the bank loaned her $2,000 on a note, payable in ninety days. The note was not paid and it was renewed several times for several successive periods until September 30, 1947. When pressed for payment the debtor urged her pressing tax obligations and need of capital for expansion. At one time the bank endeavored to get her to pay $50 per week on the obligation but she failed to do this. By September, 1947, the debtor asked the bank for an additional loan, which was refused. A financial statement showed a net worth as of October

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[72]Harrison v. Merchants National Bank, 124 F.2d 871 (8th Cir., 1942); Bostian v. Levich, 134 F.2d 284 (8th Cir., 1943).

[73]In re Cox, 132 F.2d 881, 883 (7th Cir., 1943).

31, 1947, of $19,450. It showed liabilities of $39,000, including a bank overdraft of $3,217, accounts payable of $22,805, tax liabilities in excess of $5,200. Listed as assets were $14,120 in furniture and fixtures "taken from the books," and an item designated "lease holdings" amounting to $51,159. The statement was returned to her when credit was denied. Between September 30th and December 6th, the bank note remained unpaid. During this period she had substantial overdrafts for amounts as high as $5,100. On December 6, 1947, the bank obligation, which had been reduced to $1,500 by payments in October, was again renewed for 90 days. The debtor had been negotiating for the sale of some of her establishments. On January 23, 1948, she paid off the note from the proceeds of the sale of one of her shops. She had sold six when bankruptcy intervened.

An involuntary petition was filed against her on March 5, 1948. The trustee brought plenary action to recover the sum of $1,600, which the bank had received on its notes within the four-months period preceding March 5, 1948, when the petition was filed. On appeal, it was argued by the bank that they did not know of insolvency, and that the circumstances under which the payments were made were not such as to lead them to believe that the debtor was insolvent.

The Court of Appeals rejected the contention. So doing, the Court laid down the principle already declared that mere suspicion is not sufficient, saying:

> "The creditor cannot be charged with knowledge, or its equivalent, where a mere ground for suspicion exists. *Grant* v. *National Bank,* 97 U.S. 80, 24 L. Ed. 971. He should not be required to make inquiries which could only appear necessary after he had the hindsight of later events. Due regard must be had for what is common business practice—the standards of the 'prudent business person' should not be unrealistic."[74]

On the facts it concluded:

> "It appears that the debtor was in financial difficulties throughout the period following her securing this loan. Her inability to pay the note when due, or at the successive due dates of the renewals, or even on a weekly partial-payment basis, coupled with her large overdrafts, indicate that she could not meet her obligations generally as they matured, and this condition appeared chronic at least after 1947. . . . One symptom of illness was the large amount of tax delinquency—failure to account for withholding and unemployment taxes suggests a desperate plight on the part of any employer. The bank is fairly chargeable with knowledge of the figures given in the August 31 statement. . . . In our view the facts shown to have come to the attention of the bank manager were such that the trial court might well

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[74]Security First National Bank v. Quittner, 176 F.2d 997, 998 (9th Cir., 1949). *See* R. H. Herron Co. v. Moore, 208 Fed. 134 (9th Cir., 1913); In re Gordon, 38 F.2d 73 (9th Cir., 1930); National Bank of Bakersfield v. Moore, 247 Fed. 913 (9th Cir., 1918); Sears v. Schlotzhauer, 106 F.2d 952 (9th Cir., 1939).

conclude, as it did, that a reasonably prudent creditor thus informed would have had a look at the debtor's assets, and so have observed her insolvent condition. Under these circumstances, the bank must be charged with knowledge of what ordinary prudence would have disclosed."[75]

On the whole, however, it is not enough that the creditor have reason to suspect the insolvency of the debtor. Facts must come to his knowledge which would induce a reasonable belief in the debtor's actual insolvency.[76]

VIII. *Summary or Plenary Action*

Preferences give rise to the ever-recurring problem whether the action to be brought is to be a plenary action or whether the preference can be set aside by summary proceedings. Here we are brought into the realm of law where, in each instance, it must be determined whether the claim asserted is merely colorable, in which event, summary procedure will reach it or is asserted in good faith under circumstances which call for plenary action.

Involved also is the question of actual or constructive possession of the bankrupt at the time of adjudication. The courts have sustained proceedings

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[75]Security First National Bank v. Quittner, 176 F.2d 997, 998 (9th Cir., 1949). For an almost identical situation also involving a bank, *see* Pender v. Chatham Phenix National Bank & Trust Co., 58 F.2d 968 (2d Cir., 1932).

[76]Cate v. Certainteed Products Corp., 23 Cal.2d 444, 144 P.2d 335 (1937). *See* Gray v. Little, 97 Cal.App. 442, 275 Pac. 870 (1929); Valley National Bank v. Westover, 112 F.2d 61 (9th Cir., 1940); Cusick v. Second National Bank, 115 F.2d 150 (U.S. App. D.C., 1940). The classic statement of this principle is that in Grant v. National Bank, 97 U.S. 80, 81-82 (1877):

> "It is not enough that a creditor has some cause to suspect the insolvency of his debtor; but he must have such a knowledge of facts as to induce a reasonable belief of his debtor's insolvency, in order to invalidate a security taken for his debt. To make mere suspicion a ground of nullity in such a case would render the business transactions of the community altogether too insecure. It was never the intention of the framers of the act to establish any such rule. A man may have many grounds of suspicion that his debtor is in failing circumstances, and yet have no cause for a well-grounded belief of the fact. He may be unwilling to trust him further; he may feel anxious about his claim, and have a strong desire to secure it—and yet such belief as the act requires may be wanting. Obtaining additional security, or receiving payment of a debt, under such circumstances is not prohibited by law. Receiving payment is put in the same category, in the section referred to, as receiving security. Hundreds of men constantly continue to make payments up to the very eve of their failure, which it would be very unjust and disastrous to set aside. And yet this could be done in a large proportion of cases if mere grounds of suspicion of their solvency were sufficient for the purpose.
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> "The debtor is often buoyed up by the hope of being able to get through with his difficulties long after his case is in fact desperate; and his creditors, if they know anything of his embarrassments, either participate in the same feeling, or at least are willing to think that there is a possibility of his succeeding. To overhaul and set aside all his transactions with his creditors, made under such circumstances, because there may exist some grounds of suspicion of his inability to carry himself through, would make the bankrupt law an engine of oppression and injustice. It would, in fact, have the effect of producing bankruptcy in many cases where it might otherwise be avoided."

under either form.[77] In a late case arising in this Circuit, a corporation was compelled to return property upon a summary order.[78]

The case involved a fraudulent conveyance. Nevertheless, I believe the ruling to be applicable to a case of straight preference arising under similar conditions.

IX. *Set Off of Additional Credit*

Subdivision (c) of section 60 reads:

> "If a creditor has been preferred and afterward in good faith gives the debtor further credit without security of any kind for property which becomes a part of the debtor's estate, the amount of such new credit remaining unpaid at the time of the adjudication in bankruptcy may be set off against the amount which would otherwise be recoverable from him."[79]

This provision was carried over from the prior act. It aims to allow a creditor who has received a preference and who, in good faith, later advances further credit for property which becomes a part of the debtor's estate, to set off the amount of such new credit against the amount due from him on the recoverable preference. The conditions which, therefore, must concur before this is accomplished are these: (a) There must have been a preference. (b) Credit must have been extended in good faith. (c) And without security. (d) The property must have become a part of the debtor's estate. And (e) the amount must remain unpaid.

The Supreme Court gave us an authoritative interpretation of this section shortly after it was cast in the present form in 1903.[80] On August 20, 1898, the debtor filed his petition in bankruptcy upon which an adjudication was later made. Later, the trustee began suit in a state court of

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[77]Cunningham v. Brown, 265 U.S. 1 (1924); Thompson v. Magnolia Petroleum Co., 309 U.S. 478 (1940). *See* the writer's opinion in In re Rand Mining Co., 71 F.Supp. 724, 730 (S.D. Cal., 1947) *et seq.* *See* Arkansas Fuel Oil Co. v. Leisk, 133 F.2d 79, 80 (5th Cir., 1943), where the Court comments: "No one has objected to the propriety of proceeding summarily rather than by plenary action."

[78]Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215 (1941). *See* D. M. Oldham, *Summary Jurisdiction in Bankruptcy,* 23 JOURNAL N.A.B.R. 26 (1948); Reuben G. Hunt, *Summary Proceedings in Bankruptcy,* 22 JOURNAL N.A.R.B. 109 (1948). It should be noted that, if the preference is voidable, the trustee may recover the property, or, *if it has been converted,* its value from any person who has received the property except a purchaser for value or a lienor of the debtor's transferee for a present fair equivalent value. Where the purchaser or transferee has given less than value, he is given a lien to the extent only of the consideration paid. Bankruptcy Act, § 60(b), 11 U.S.C.A., § 96(b). To make this clause applicable, a conversion *ex maleficio* under federal law must occur. Perkins v. Remillard, 84 F.Supp. 224, 226-228 (D.C. Mass., 1949). This excludes what has been called "the free option" of the trustee to ask for the property or its value under the prior section. And the court must be satisfied that a conversion occurred to the extent that the preferee cannot return the identical property "in substantially as good condition as when the bankrupt had it." Perkins v. Remillard, *supra* at 227. *See* RESTATEMENT, TORTS, § 226. *See also* Arkansas Fuel Oil Co. v. Leisk, 133 F.2d 79 (5th Cir., 1943). *See* Robert Oglebay, *Some Developments in Bankruptcy Law,* 24 JOURNAL N.A.R.B. 24, 25 (1950).

[79]Bankruptcy Act, § 60(c), 11 U.S.C.A., § 96(c).

[80]Kaufman v. Tredway, 195 U.S. 271 (1904).

Pennsylvania to recover the sum of $4,086.64, charged to have been given on August 4, 1898, by the bankrupt to the defendant as a preference. The trial resulted in a judgment in favor of the trustee for $1,086.64. The judgment was affirmed by the state court. Appeal to the Supreme Court of the state was denied. The Supreme Court took over the case on a writ of error. The question before the Court was whether the sum of $767, loaned to the bankrupt by his brother, could be considered a set-off. It appeared that four days after he had received the money paid to him in preference, the defendant handed to the bankrupt $767 on the latter's request for him to pay his employees. There was no showing that it was actually used for that purpose. But the trial court instructed the jury that the defendant had not established his claim to a set-off. The trial court took the view that it was necessary to show before the set-off was allowed that the claimed set-off remained a part of the estate *until the time of bankruptcy*, and was transferred to the trustee or, at least, that it was used in payment of preferred debts. The Court rejected this contention, saying:

> "*It is the non-payment and not the fact that the property remains still a part of the debtor's estate which entitles to a set-off.* It would seem that if Congress intended that which the trial court held to be the meaning of the statute it would have said 'which becomes and remains a part of the debtor's estate until the adjudication in bankruptcy.'
>
> "Further, Congress provided that the creditor act in good faith. Thus it excluded any arrangement by which the creditor, seeking to escape the liability occasioned by the preference he has received, passes money or property over to the debtor with a view to its secretion until after the bankruptcy proceedings have terminated, or with some other wrongful purpose. It meant that the creditor should not act in such a way as to intentionally defeat the bankrupt act, but should let the debtor have the money or property for some honest purpose. Requiring that it should become a part of the debtor's estate excluded cases in which the creditor delivered the property to a third person on the credit of the debtor, or delivered it to him with instructions to pass it on to some third party. The purpose was that the property which passed to the creditor should, in fact become a part of the debtor's estate, and that the credit should be only for such property."[81]

Thus the Court sanctioned as the only conditions for the set-off that credit should have been extended without security, in good faith and that the money actually pass to the debtor's possession, regardless of whether the money remained in the debtor's estate up to the time of bankruptcy. Later cases have followed this interpretation.[82]

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[81]Kaufman v. Tredway, *supra* at 274.

[82]Wertz v. National City Bank, 115 F.2d 65 (7th Cir., 1904); 3 COLLIER ON BANKRUPTCY, 14th ed., § 60.67. Where there is a conversion and no surrender, set-off is not allowed. Arkansas Fuel Oil Co. v. Leisk, 133 F.2d 79 (5th Cir., 1942).

X. *Surrender of Preferences*

One other matter remains to be adverted to. Section 57(g) of the Bankruptcy Act reads:

> "The claims of creditors who have received or acquired preferences, liens, conveyances, transfers, assignments or encumbrances, void or voidable under this title shall not be allowed unless such creditors shall surrender such preferences, liens, conveyances, transfers, assignments, or encumbrances."[83]

He who receives a preference subjects himself to action by the trustee to recover it.[84] In addition to this, the clause just referred to penalizes him by refusing to allow his other claims in bankruptcy unless he surrenders the preference. The object of this section has been stated in this manner:

> "The purpose of the surrender clause in section 57g is not to prescribe the only conditions under which or the only preferences which must or can be surrendered. It was much narrower; to prevent allowance of the claims or participation in the administration of the estate by creditors having certain designated preferences (which were in fraud of the act) until those preferences were abandoned."[85]

The aim is to compel the surrender of the preference as a condition to the allowance of debts in the course of administration. This being shown, it matters not that the surrender is achieved by legal coercion.

The Supreme Court made this clear in an early case by interpreting the word "surrender" as "capable of denoting either compelled or voluntary action." The basic philosophy for this conclusion is contained in this pithy statement:

> "Equality of distribution being the purpose intended to be effected by the provision, to interpret it as forbidding a creditor from proving his claim after a surrender of his preference, because such surrender was not voluntary, would frustrate the object of the provision, since it would give the bankrupt estate the benefit of the surrender or cancellation of the preference, and yet deprive the creditor of any right to participate, thus creating an inequality."[86]

It is thus apparent that if the creditor refuses to surrender the preference, his additional claims will be rejected.[87] And it is axiomatic that if the preference is neither void nor voidable, because of the presence of the elements which place it beyond the reach of the bankruptcy court, the creditor is entitled to have his additional claims allowed.

Thus, in one instance which arose in the Ninth Circuit, the Court, having found that, although the creditor, a wholesaler, had received approximately

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[83] Bankruptcy Act, § 57(g), 11 U.S.C.A., § 93(g).

[84] Bankruptcy Act, § 60(b), 11 U.S.C.A., § 96(b).

[85] Barks v. Kleyne, 15 F.2d 153, 156 (8th Cir., 1926); *see* McAbee v. Isom, 116 F.2d 1001 (5th Cir., 1940).

[86] Keppel v. Tiffin Savings Bank, 197 U.S. 356, 361 (1905); *see* Page v. Rogers, 211 U.S. 575 (1909); 2 REMINGTON ON BANKRUPTCY, 4th ed., §§ 936-939.

[87] In re Jameson & Meyers, 32 F.2d 999 (9th Cir., 1929).

50 per cent of its claim, in 26 payments over a period of four months, the payments having been made to the wholesaler in due course of business, and he not being chargeable with reasonable cause to believe that the payments constituted a preference under the old act, he was allowed a claim for the balance of the debt in the sum of $20,000.[88]

These rulings apply logically the fundamental purpose of the provisions against preferences which the Supreme Court has stated to be "to secure an equality of distribution of the assets of a bankrupt estate."[89]

XI. *Conclusion*

So we end this discussion upon the same *theme* upon which it was begun, i. e., *equality.*

The object of the bankruptcy law and of the provisions relating to preference is to achieve equality among the creditors in the distribution of the estate. In administering the act, this aim will be achieved by interpreting broadly the powers given to courts to set aside preferences or to compel their surrender. Such interpretation should not, however, call for turning into voidable preferences advantages not condemned by bankruptcy law which are given to creditors under state law.

The transactions out of which the relation of debtor and creditor arises are local in nature and governed by state law. All parties to the transaction deal presumably with knowledge of such law. Trustees, at times, in their zeal to achieve a desirable result in a particular case, would substitute for the legal norms established by state courts nebulous equitable principles. This is a disservice to the just balance to be maintained in all relations between state and federal jurisdictions. In the realm of bankruptcy, federal action is supreme. But, in adjudicating the rights asserted in bankruptcy, we are bidden by sound juridical principles and wise governmental policy to take into consideration the legal relationships out of which claims in bankruptcy arise. These legal relationships are, in the main, governed by state law. And the discussion which precedes shows that beneficial results can be achieved by a sane balancing of the rights defined in the Bankruptcy Act and the rights established by local law under which the transactions arise. This approach should be maintained by all—lawyers, trustees, referees and judges—who participate in the act of achieving the equality which the Bankruptcy Act and the provisions against preferences seek to establish. And it can be best maintained if accepted legal norms developed on a state basis, and by which business relations are governed, are not subverted for the sake of an illusory uniformity in the administration of the Bankruptcy Act.

[88] In re Solof, 2 F.2d 130 (9th Cir., 1924).

[89] Keppel v. Tiffin Savings Bank, 197 U.S. 356, 361 (1905). *See* cases in note 3, *supra.*